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## BEFORE THE ARIZONA CORPORATION CO

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IN THE MATTER OF THE APPLICATION OF  
LITCHFIELD PARK SERVICE COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANTS AND PROPERTY AND  
FOR INCREASES IN ITS WASTEWATER  
RATES AND CHARGES BASED THEREON  
FOR UTILITY SERVICE.

Docket No. SW-01428A-13-0042

Arizona Corporation Commission

DOCKETED

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IN THE MATTER OF THE APPLICATION OF  
LITCHFIELD PARK SERVICE COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANTS AND PROPERTY AND  
FOR INCREASES IN ITS WATER RATES  
AND CHARGES BASED THEREON FOR  
UTILITY SERVICE.

Docket No. W-01427A-13-0043

## APPLICATION FOR REHEARING OF DECISION NO. 74437

Pursuant to A.R.S. § 40-253, the Residential Utility Consumer Office ("RUCO") hereby  
applies for rehearing of Decision No. 74437, docketed on April 18, 2014 (the "Decision" or  
"Order").

1       **I. BACKGROUND**

2       On February 28, 2013, Liberty Utilities (Litchfield Park Water & Sewer) Corp. ("LPSCO" or  
3 "Company") filed the above-captioned rate applications with the Arizona Corporation  
4 Commission ("Commission"). On April 18, 2014, the Commission issued Decision No. 74437  
5 granting the Company's rate application. Testimony was filed by the parties and Settlement  
6 Discussions were held regarding the case. On December 11, 2013, the Company filed a  
7 Settlement Agreement with the Commission that was executed by Staff and the Company and  
8 RUCO. The Settlement reached by the parties resolved all the outstanding issue except the  
9 System Improvement Benefits ("SIB") mechanism for both the Company's water and the  
10 wastewater systems.

11       The hearing in this matter took place on December 6 and 13, 2013. The ALJ subsequently  
12 issued her Recommended Opinion and Order ("ROO"). The ROO recommended approval of  
13 the Settlement Agreement as well as the water and the wastewater SIBs. RUCO filed  
14 Exceptions and the case was heard at Open Meeting on April 8, 2014. The Commission  
15 approved the ROO as by a 5-0 vote.

16       **1) THE COMMISSION SHOULD NOT HAVE APPROVED THE SIB FOR THE**  
17       **WASTEWATER DIVISION**

18       This is the first case the Commission is considering the wastewater SIB. The Company has the  
19 burden of showing why a wastewater SIB is necessary. RUCO believes that the needed  
20 infrastructure could be addressed through traditional ratemaking which would provide  
21 safeguards for the ratepayer. At the very least, the Company needs to show why extraordinary  
22 ratemaking is required here. No such showing has been made. It is not enough to assume  
23 that a wastewater surcharge mechanism is necessary in this case just because the  
24 Commission has in the past approved a water surcharge mechanism for other utilities. Again,

1 the facts of this case are different, the circumstances of this case are different, and the needs  
2 of this Company are different.

3 At the hearing there was testimony that the wastewater SIB Plan of Administration  
4 ("POA") was written by Staff with the collaboration of the Company shortly before the hearing  
5 in this matter. There was no showing in this case why a SIB is necessary for wastewater.  
6 Exhibit C of the Decision is Table 1 of the wastewater SIB. RUCO does not take issue with the  
7 narratives explaining the improvements. That misses the point – plant improvements are part  
8 of providing service and part of the regulatory compact. Exhibit C does not explain, nor is  
9 there any testimony explaining why we need extraordinary ratemaking for routine  
10 improvements to wastewater plant.

11 Moreover, unlike the Eastern Division case, the wastewater POA was not the result of  
12 many parties coming together which included other wastewater utilities and utility investment  
13 groups. Wastewater infrastructure is different than water infrastructure. Concerns such as  
14 water loss which was the origin of the DSIC are not relevant with wastewater. The Commission  
15 should not act as a rubber stamp, approving every application that comes before it – there  
16 needs to be an express showing in each case to support approval. There is no reason why the  
17 Company cannot request the repair and/or replacement of its wastewater infrastructure in a  
18 traditional rate case where the infrastructure itself and all the costs and savings associated  
19 with it can be scrutinized with the normal safeguards to the ratepayer –resulting in just and  
20 reasonable rates.

21 **2) THE WATER AND WASTEWATER SIB IS ILLEGAL**

22 **A) THE SIB SHIFTS RISK FROM THE COMPANY TO THE**  
23 **RATEPAYER WITHOUT ADEQUATE FINANCIAL**  
24 **CONSIDERATION TO THE RATEPAYER**

1 RUCO opposes the SIB (for water and wastewater – for ease of reference every  
2 SIB notation applies to both water and wastewater unless otherwise indicated) because  
3 ratepayers are not adequately compensated for the additional risk associated with the SIB  
4 and because it is illegal. The SIB mechanism reduces regulatory lag in favor of Chaparral  
5 because the Company will not have to wait until new rates go into effect to recover a return  
6 on SIB eligible plant or the depreciation expense associated with it. However, any actual  
7 cost savings, such as lower operating and maintenance expenses, attributable to the new  
8 plant are not truly captured by the mechanism and are not adequately flowed through to  
9 ratepayers. The reason for the mismatch is the SIB filings will consider eligible plant  
10 placed in service after the time period considered in the rate case. Hence, the operating  
11 expenses associated with the SIB plant as well as all of the other rate case elements  
12 normally considered in a rate case will not be factored into the calculation. This mismatch  
13 works against the ratepayer's interests and assures that ratepayers will not pay their actual  
14 cost of service and will pay more over time.

15 Ratepayers will be paying for the recovery of and return on routine plant placed into  
16 rate base in between rate cases that the ratepayer would not otherwise pay until the next  
17 rate case. To the extent the ratepayer receives a benefit through the efficiency credit on  
18 the return associated with the SIB related plant that paltry benefit will only accrue until the  
19 next rate case filing when the relevant plant is rolled into the rate base and subject to the  
20 COE awarded in the next rate case.

21 Another financially related argument advanced in support of the SIB is that the SIB  
22 will promote rate gradualism. While the SIB may promote rate gradualism, it comes at a  
23 cost. Ratepayers are very likely to pay higher rates over time because of the failure to  
24 consider all of the rate case elements at each SIB filing. Gradualism will also come at the

1 expense of rate stability. Id. Ratepayer's rates will change yearly as the result of each SIB  
2 filing.

3 Each filing will also result in a rate increase. For reasons which will be addressed  
4 below, the SIB is not an adjustor. Ratepayers will see no actual cost savings that might  
5 otherwise be realized without extraordinary ratemaking and will no longer benefit from the  
6 rate stability that exists under traditional ratemaking.

### 7 **B) THE SIB IS NOT AN ADJUSTOR MECHANISM**

8 The Arizona Constitution protects consumers by generally requiring that the  
9 Commission only change a utility's rates in conjunction with making a finding of the fair  
10 value of the utility's property.<sup>1</sup> However, Arizona's courts recognize that, "in limited  
11 circumstances," the Commission may engage in rate making without ascertaining a utility's  
12 rate base.<sup>2</sup> One of those circumstances exists where the Commission has established an  
13 automatic adjustor mechanism. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578  
14 P.2d 612, 616; *Residential Util. Consumer Office v. Arizona Corp. Comm'n* ("Rio Verde  
15 13e"), 199 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172. An automatic adjustor mechanism  
16 permits rates to adjust up or down "in relation to fluctuations in certain, narrowly defined,  
17 operating expenses." *Scates* at 535, 578 P.2d 616. An automatic adjustor permits a  
18 utility's rate of return to remain relatively constant despite fluctuations in the relevant  
19 expense. An automatic adjustor clause can only be implemented as part of a full rate  
20 hearing. *Rio Verde* at 592 ¶ 19, 20 P.3d 1173, citing *Scates* at 535, 578 P.2d 616.

21  
22  
23 <sup>1</sup> Arizona Constitution. Art. XV, § 14; *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 151, 294  
24 P.2d 378, 382 (1956); see also *State v. Tucson Gas*, 15 Ariz. 294, 308; 138 P.781, 786 (1914); *Arizona  
Corporation Commission v. State ex rel. Woods*, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992).

<sup>2</sup> *Residential Utility Consumer Office v. Arizona Corporation Commission*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d  
1169, 1172 (App. 2001).

1 The Commission has also defined adjustor mechanisms applying to expenses that  
2 routinely fluctuate widely. In a prior decision in which it eliminated APS' fuel and power  
3 adjustor, the Commission stated:

4 The principle justification for a fuel adjustor is volatility in fuel  
5 prices. A fuel adjustor allows the Commission to approve  
6 changes in rates for a utility in response to volatile changes in  
fuel or purchased power prices without having to conduct a rate  
case. (Decision No. 56450, page 6, April 13, 1989).

7 The Commission went on to discuss the undesirability of such adjustors because they can  
8 cause piecemeal regulation that is inefficient and undesirable. See also *Scates* at 534,  
9 578 P.2d 615.

10 In the subject case, the SIB clearly is not an adjustor mechanism – its purpose is  
11 not to account for fluctuating operating expenses. Its purpose is to allow for recovery of  
12 plant costs which increases rate base and thereby increases operating income – not  
13 operating expenses. Unlike an adjustor, the SIB does not allow for rates to adjust “in  
14 relation to fluctuations in certain, narrowly defined, operating expenses.” Moreover, the  
15 SIB only permits rates to adjust up, not down as the result of allowing for the SIB related  
16 plant recovery.

17 Even if one could set aside the argument that Arizona's courts have only recognized  
18 adjustors for very limited operating expenses and not for operating income, the SIB  
19 mechanism still would not qualify as an adjustor because the justification for the  
20 mechanism is not the volatility in the price of the plant. As explained, the concern here is  
21 the amount of the investment, and no case law parities the need for an adjustor  
22 mechanism with the magnitude of investment in plant. The SIB is not an adjustor  
23 mechanism nor should the exception be expanded in any manner to treat it as such.

24 **C) THE COMPANY HAS NOT REQUESTED INTERIM RATES**

1 The only other circumstance where the Commission may engage in rate making  
2 without ascertaining a utility's rate base involves requests for interim rates.<sup>3</sup> The  
3 Commission's authority to establish interim rates is limited to circumstances in which 1) an  
4 emergency exists; 2) a bond is posted guaranteeing a refund if interim rates are higher  
5 than final rates determined by the Commission; and 3) the Commission undertakes to  
6 determine final rates after making a finding of fair value.<sup>4</sup> The Arizona Attorney General  
7 has opined that an emergency exists when "sudden change brings hardship to a company,  
8 when a company is insolvent, or when the condition of the company is such that its ability  
9 to maintain service pending a formal rate determination is in serious doubt."<sup>5</sup>

10 The Company has not asserted an emergency nor requested interim rates.  
11 Regardless, and perhaps the reason why the Company has not asserted an emergency, is  
12 because the Company would not meet the legal criteria – there is no evidence of a sudden  
13 change that has brought hardship, no insolvency issue, or evidence that the Company has  
14 an inability to maintain service in the interim or long term for that matter.

15 **D) THE SIB WOULD NOT QUALIFY UNDER THE 'THIRD**  
16 **EXCEPTION'**

17 The Eastern Division Phase II Decision (No. 73938) lists what it refers to as a "third  
18 exception" contemplated by the Arizona Courts to the fair value requirement. Citing  
19 *Scates*, Decision No. 73938 references the following:

20 We do not need to decide in this case whether as a matter of  
21 law there must be a de novo compliance with all provisions of  
22 the order in connection with every increase in rates. The  
23 Commission here not only failed to require any such  
submissions, but also failed to make any examination  
whatsoever of the company's financial condition, and to make  
any determination of whether the increase would affect the

24 <sup>3</sup> *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-35, 578 P.2d 612, 614-16 (App. 1978).

<sup>4</sup> 199 Ariz. at 591, ¶12, citing *Scates*.

<sup>5</sup> 71-17 Opinion Arizona Attorney General at 50. (1971).

1 utility's rate of return. There may well be exceptional situations  
2 in which the Commission may authorize partial rate increases  
3 without requiring entirely new submissions. We do not decide in  
4 this case, for example, whether the Commission could have  
referred to previous submissions with some updating or  
whether it could have accepted summary financial information.

(118 Ariz. 531, at 537, 578 P.2d 612, at 618).

5 RUCO believes that an unabridged gap exists between a conclusion that a third  
6 exception exists and that the Arizona courts have determined that a third exception exists.  
7 *Scates* did define what was needed for interim rates – an emergency which is far more  
8 tangible than a mere directive. *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578  
9 P.2d 612, 616 (App. 1978). *Scates* also explained that an automatic adjustor is a device  
10 that permits rates to adjust as explained above. RUCO is unaware of any case<sup>6</sup> in Arizona  
11 that specifically identifies and sets forth the criteria for a third exception. Moreover, the  
12 Commission, if anything should be looking to narrow, not expand the exception to  
13 Arizona's Constitutional requirement that fair value be found. The provisions of Arizona's  
14 Constitution should be liberally construed to carry out the purposes for which they were  
15 adopted. *Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111 (1984). Conversely, exceptions to a  
16 constitutional requirement should be narrowly construed. See *Spokane & I.E.R. Co. v.*  
17 *U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule" that exceptions  
18 from a general policy embodied in the law should be strictly construed). The Commission  
19 should not use the "emergency" exception or the adjustor mechanism exception liberally or  
20 create a "third exception" to set aside the rule of finding fair value when setting rates.

21 If a third exception does exist, the SIB in this case should not qualify. There has to  
22 be some meaning to the notion of a fair value finding and that meaning should not be  
23 sidestepped by simply providing narrow updates to a previously determined rate base.  
24



1 There is hardly anything extraordinary about a utility that needs to replace aging  
2 infrastructure. In fact, it is normal and usually the reason why a utility files a rate case.  
3 The SIB will be precedent for any utility to seek extraordinary ratemaking to include routine  
4 plant for recovery in between rate cases.

5 **E) THE SIB WILL INCREASE THE COMPANY'S FAIR VALUE RATE**  
6 **BASE WITHOUT ANY DETERMINATION OF FAIR VALUE**

7 Having established that the SIB does not meet any of the criteria required by  
8 Arizona's Courts to side-step the Constitution's fair value requirement, the question then  
9 becomes whether or not the SIB complies with the Constitution's fair value requirement.  
10 First, it is important to recognize what the SIB is – it is a mechanism, not an adjustor  
11 mechanism, which will allow for the recovery of, and a return on routine plant in between  
12 rate cases, needed to address the Company's normal and recurring plant and  
13 improvement needs.

14 The SIB mechanism itself will be established as part of the pending rate case.  
15 Within 12 months of the date of the Commission's final decision, the Company will be able  
16 to file a request to implement the SIB surcharge. The Company will be able to file for the  
17 SIB surcharge no more than five times between rate case decisions. The Commission will  
18 ultimately consider and then may approve each surcharge filing. The Commission,  
19 however, will not be making a new FVRB finding as part of each surcharge filing. It will be  
20 updating the prior fair value finding with the new SIB related plant and associated  
21 depreciation expense. It will not consider other expenses and revenues in the calculation.  
22 The SIB will do far more than simply pass on increasing costs to the Company - it will allow  
23 for increasing rates in between rate cases based on the costs of routine plant effectively  
24 increasing the fair value rate base without a meaningful consideration of fair value. The

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<sup>6</sup> Clearly Scates does not define a third exception.

1 fact that the Company will be subject to an annual earnings test and will have to file  
2 balance sheets, income statements and other financial information does not cure the  
3 constitutional infirmity.

4 The financial filings are covered in SIB Schedule D which appears to be the answer  
5 to the fair value issue from the proponents' perspective. RUCO's perspective is different—  
6 the facts are the facts and the fact is that each SIB filing will not result in a meaningful  
7 FVRB finding nor will there be any finding by the Commission of what fair value is:

8 "It is clear . . . that under our constitution as interpreted by this  
9 court, the commission is required to find the fair value of (the  
10 utility's) property and use such finding as a rate base for the  
11 purpose of calculating what are just and reasonable rates. . . .  
12 While our constitution does not establish a formula for arriving  
13 at fair value, it does require such value to be found and used as  
14 the base in fixing rates. The reasonableness and justness of  
15 the rates must be related to this finding of fair value." Simms v.  
16 Round Valley Light & Power Co., 80 Ariz. 145, 151, 294 P.2d  
17 378, 382 (1956).

18 Schedule D will show an analysis of the impact of the SIB plant on the fair value  
19 rate base, revenue, and the fair value rate of return. This provision was obviously put in to  
20 satisfy *Scates*, but it does not go far enough:

21 We do not need to decide in this case whether as a matter of  
22 law there must be a de novo compliance with all provisions of  
23 the order in connection with every increase in rates. The  
24 Commission here not only failed to require any such  
submissions, but also failed to make any examination  
whatsoever of the company's financial condition, and to make  
any determination of whether the increase would affect the  
utility's rate of return. There may well be exceptional situations  
in which the Commission may authorize partial rate increases  
without requiring entirely new submissions. We do not decide in  
this case, for example, whether the Commission could have  
referred to previous submissions with some updating or  
whether it could have accepted summary financial information.  
*We do hold that the Commission was without authority to  
increase the rate without any consideration of the overall  
impact of that rate increase upon the return of Mountain States,*

1       *and without, as specifically required by our law, a determination*  
2       *of Mountain States' rate base. Simms v. Round Valley Light &*  
3       *Power Co., 80 Ariz. 145, 294 P.2d 378 (1956); Ariz.Const. Art.*  
4       *15, section 3; A.R.S. section 40-250. The Commission not only*  
5       *failed to make any findings to support its conclusion that the*  
6       *increases were just and reasonable, but it received no evidence*  
7       *upon which such findings could be based. Scates at 537, 578*  
8       *P.2d 618. (Emphasis added).*

6       While the SIB Schedule (D) may show the impact of the SIB plant on the rate base,  
7       the revenue and the fair value rate of return, the Commission will not, as required by law,  
8       make a meaningful finding of fair value and use that finding as a rate base for the purpose  
9       of establishing rates. In the Phase II Eastern Division case, Schedule D shows the rate  
10      base (O.C.L.D.) but it only shows the capital costs and the depreciation expense  
11      associated with the plant additions. Decision No. 73938, Settlement Agreement, Schedule  
12      D. Hence, the SIB filings will only consider one piece – the SIB plant (and depreciation  
13      expense). It will not consider the operating expenses associated with that plant, the  
14      working capital, etc. in the calculation. The operating expenses that will be included in the  
15      rates that the Commission will approve after each SIB filing will be the operating expenses  
16      ultimately approved in the Decision in this case - operating expenses from a completely  
17      different period than the time period of the SIB plant under consideration. In sum, there is  
18      no tie back to fair value and the SIB raises the specter of single issue ratemaking which  
19      was a concern of the *Scates* Court. *Scates* at 534, 578 P.2d. 615. The SIB mechanism is  
20      single issue ratemaking; it is not fair value ratemaking.

21      The Plan of Administration has an earnings test calculation. While an earnings test  
22      will provide the Commission with a measure of the Company's earnings at a designated  
23      point in time, it will not cure the constitutional fair value infirmity. The earnings test is an  
24      after-the-fact indicator of whether the Company's actual rate of return exceeded its

1 authorized rate of return looking back over a designated time period. An earnings test is  
2 not relevant to an actual finding of fair value. There are other provisions which will assure  
3 Commission oversight and approval of the SIB filings but nothing that requires a  
4 meaningful finding of fair value as required by Arizona's Constitution.

5 **F) THE SIB DOES NOT SET ASIDE DEPRECIATION EXPENSE**

6 Under A.R.S. section 40-222 the Commission can order a public service corporation  
7 to set aside its depreciation expense. If the premise of water and wastewater companies is  
8 their systems/districts are in dire need of repair, and even with a SIB it is not enough, then  
9 why not reinvest monies received through depreciation expense? Instead of these monies  
10 going back to shareholders or other affiliates/companies these monies should be set aside  
11 and be used to pay for improvements and replacement of plant.

12 **G) THE SIB IS NOT IN THE PUBLIC INTEREST**

13 There are numerous reasons why RUCO does not believe the SIB is in the public  
14 interest. The SIB is illegal in Arizona, and hence not in the public interest. The SIB does  
15 not adequately compensate ratepayers for the shift in risk that will result – a five percent  
16 efficiency credit is a paltry quid pro quo.

17 For every argument made in support of the SIB, there are counter- points which  
18 weigh more heavily to reject the SIB. There is the argument that the SIB mitigates  
19 regulatory lag alluded to above. This is true; however, this benefit to the Company comes  
20 at the higher expense of regulatory scrutiny. Elimination of regulatory lag is not in the best  
21 interests of ratepayers.

22 First, regulatory lag incents the utility to operate as efficiently and as prudently as  
23 possible. Unlike most companies that must compete for customers, a monopoly utility is  
24 not subject to the inherent pressures of a competitive marketplace to manage its costs.

1 Regulatory lag addresses this problem. By having a "lag" time between when a regulated  
2 utility spends its money and begins recovery of it, regulatory lag exerts pressure on the  
3 utility to act efficiently and prudently.

4 Second, regulatory lag evens out over time. While regulatory lag may place  
5 pressure on the utility in the beginning, that same regulatory lag provides an economic  
6 benefit to the utility in the end. Once plant has been fully depreciated, the utility still earns  
7 recovery of (and recovery on) that plant until the next rate case, which may be several  
8 years past when the plant was fully depreciated.

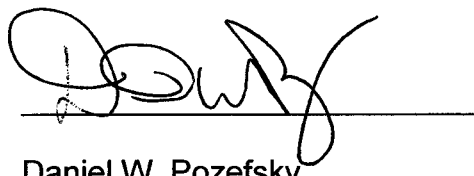
9 A SIB eliminates regulatory lag on the front end (to the benefit of the utility) at the  
10 risk of reducing pressure to operate prudently and efficiently (to the detriment of the  
11 ratepayer).

12 Aside from regulatory lag and the various other arguments, quite simply the SIB is  
13 poor ratemaking as far as the ratepayer is concerned. The SIB is a mechanism that lets a  
14 utility add in-between rate cases gross plant less related depreciation expense to a rate  
15 base determined in a prior rate case. The ratepayer is not protected and a small, token  
16 efficiency credit is not equal to the hope that the end result will imitate or even be close to  
17 the rates the ratepayer would get if all of the rate case elements were scrutinized and  
18 applied as would be required in a rate case.

### 19 3) CONCLUSION

20 The SIB mechanism does not comport with the requirement that rates be set only upon  
21 a finding of fair value, as it does not qualify as a true adjustor mechanism. The Commission  
22 should rehear Decision No. 74437 to reject the SIB.

1  
2 RESPECTFULLY SUBMITTED this 24th day of April, 2014.

3  
4 

5 Daniel W. Pozefsky

6 Chief Counsel

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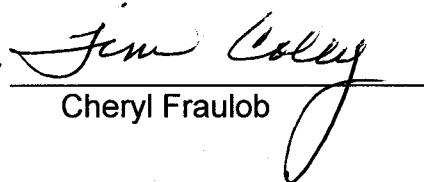
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